<u>Editor's note</u>: 96 I.D. 367; <u>appeal</u> <u>filed</u>, No. 90-191-L (Cl. Ct. Mar. 1, 1990)
Solicitor's Office says was settled but does not have date

TRANSCO EXPLORATION CO.

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TXP OPERATING CO.

IBLA 86-1467 Decided September 13, 1989

Appeal from a decision of the Director, Minerals Management Service, determining that $1,416,084.09 was due as a result of underpayment of gas royalties between March through August 1980, and August 1982 through September 1983, attributable to production on lease OCS-G 1960. MMS 83-46-OCS.

Affirmed.

1. Outer Continental Shelf Lands Act: Oil and Gas Leases--Regulations: Interpretation--Rules of Practice: Generally

   The procedures set forth at 30 CFR 250.70 through 250.80 (1987) only apply in those cases involving the assessment of a civil penalty.

2. Notice: Constructive Notice--Rules of Practice: Generally

   Where an oil and gas lessee has entered into a seller's representative agreement and designated the operator of the lease as its representative for the tender of royalty payments to the United States, service of documents relating to those payments on the operator constitutes effective service upon the lessee.

3. Outer Continental Shelf Lands Act: Oil and Gas Leases--Rules of Practice: Appeals: Generally

   Where MMS issues an order requiring the submission of additional past royalties and thereafter denies a request from the lessee that it be permitted to post a bond in lieu of tendering the money during the pendency of an appeal, the failure of the lessee to appeal from the decision of MMS denying the request to post a bond and the subsequent tender of the amount demanded constitutes a waiver of any objection to the requirement that the money be tendered during the pendency of the appeal.

4. Oil and Gas Leases: Royalties: Generally--Outer Continental Shelf Lands Act: Oil and Gas Leases

   Where the appropriate Oil and Gas Supervisor issues a letter determining the proper method of computing royalties owed to the United States based on the assumption that the natural gas involved is subject to price control, and that gas is subsequently decontrolled, the letter ceases to be a valid basis for the computation of the amount of royalty due to the United States.

5. Oil and Gas Leases: Royalties: Generally--Outer Continental Shelf Lands Act: Oil and Gas Leases

   As a general rule, "reasonable value" for the purpose of calculating royalties due to the United States will be the highest price paid for the major portion of like quality products produced or sold from the same field or area or the gross proceeds actually received by the lessee, whichever is higher.

6. Oil and Gas Leases: Royalties: Generally--Outer Continental Shelf Lands Act: Oil and Gas Leases

   Where royalty payments are dependent upon the price at which the product is marketed, oil and gas lessees are generally deemed to have an implied obligation to exercise good faith in the marketing of the production from the lease, though claims for increased royalties are subject to the defense that the lessee exercised reasonable business judgment. Where, however, for no justifiable reason, a lessee fails to timely invoke a clause permitting renegotiation of the price received with the result that royalties continue to be based on a lower price, the lessee is properly required to tender additional royalties based on the prices received by other lessees who timely invoked similar renegotiation provisions.

7. Oil and Gas Leases: Royalties: Generally--Outer Continental Shelf Lands Act: Oil and Gas Leases

Where a Federal oil and gas lessee voluntarily agrees to reduction in the price paid for oil or gas by an affiliated purchaser, and the evidence establishes that, but for the affiliated relationship between the lessee and the purchaser, a higher price would have been obtained for the production, the lessee is properly deemed to have breached its duty of fair dealing with the lessor and royalty is properly computed based on the prices received by other lessees who had similar contractual arrangements with the producer but who refused to assent to lower payments for their production from the same lease.

APPEARANCES: Rene P. Lavenant, Jr., Esq., M. W. Parse, Jr., Esq., and Robert L. McIntyre, Esq., Houston, Texas, for appellants; Peter J. Schaumberg, Esq., and Kathleen L. Walz, Esq., Office of the Solicitor, Washington, D.C., for the Minerals Management Service.

OPINION BY ADMINISTRATIVE JUDGE BURSKI

Appellants Transco Exploration Company (TXC) and TXP Operating Company (TXPO) have appealed from a decision of the Director, Minerals Management Service (MMS), dated April 18, 1986, finding that, for the period March through August 1980, and August 1982 through September 1983, appellants undervalued production attributable to their 15-percent working interest share of gas from Outer Continental Shelf Lands (OCS) oil and gas lease OCS-G 1960 and that the value of the production should be determined by reference to the price received by Enstar Petroleum Company (Enstar) pursuant to its contract with Transcontinental Gas Pipeline Corporation (Transcontinental).

Oil and gas lease OCS-G 1960, South Timbalier Block 148, offshore Louisiana, was issued pursuant to the Outer Continental Shelf Lands Act (OCSLA), 43 U.S.C. § 1331 (1982), effective February 1, 1970. The undivided working interest in OCS-G 1960 is held by Chevron USA, Inc. (Chevron), 40 percent; Enstar and five other companies, which are collectively referred to herein as Enstar, 45 percent; and TXC, 15 percent. Enstar was the designated operator for the lease. 1/

By assignment dated July 15, 1983, TXC transferred its interest in OCS-G 1960 to TXPO, a Texas limited partnership in which TXC is the managing general partner. Transco Energy Company, the parent-corporation of both TXC and TXPO, is a special general partner and Transco Exploration Partners, Ltd., a Texas limited partnership, is the sole limited partner in TXPO. TXC and TXPO are similarly situated for purposes of this appeal and will hereinafter be collectively referred to as "appellants."

Between November 1977 and December 1978, TXC, Chevron, and Enstar separately entered into three substantially similar long-term gas purchase contracts with Transcontinental for the disposition of their respective working interest share of gas from OCS-G 1960. TXC's contract with Transcontinental was dated November 16, 1977; Enstar's contract with Transcontinental was dated December 15, 1977; and Chevron's contract with Transcontinental was

1/ Enstar Petroleum Company eventually became the successor-in-interest to C&K Marine Production Company (C&K), which had initially entered into the gas-purchase contract with Transcontinental. However, in order to lessen the likelihood for confusion, we will refer to the operator and holder of the 45-percent interest as Enstar throughout this opinion.

dated September 11, 1978. The date of first delivery of production under all three contracts was February 11, 1979.

The contracts between Transcontinental and Chevron, and Transcontinental and Enstar were between nonaffiliated parties. However, since Transcontinental, like TXC, is a wholly owned subsidiary of Transco Energy Company, the contract between TXC and Transcontinental was between affiliated parties and, by definition, was not at arm's length. 2/

Transcontinental's contracts with Enstar and TXC, respectively, were identical in all respects, including quantity, price, and term. Thus, both contracts required Transcontinental "to receive or pay for if available for delivery and not taken" (take or pay) an average daily contract minimum quantity of gas well gas equivalent to 90 percent of seller's (Enstar and TXC's) delivery capacity for the first 5 years and 80 percent of seller's delivery capacity for the remainder of the term of the contract (compare Enstar-Transcontinental contract at 10 with TXC-Transcontinental contract at 10). Both contracts originally provided for a 5-year makeup period (makeup) during which Transcontinental could makeup or recover (in kind only) deficiencies where it had paid for gas volumes which were previously available but

2/ The fact that a contract is not at arm's length does not, of course, make the contract invalid. However, in such a situation the Department will not assume that the negotiated price represents fair market value unless there is independent indicia establishing that the contract price is one fairly derived from the marketplace. See generally Getty Oil Co., 51 IBLA 47, 51 (1980). As the subsequent text makes clear, there is no question that the original contract between TXC and Transcontinental resulted in a price reflective of other contracts being entered into at that time. The issues presented by this appeal relate to subsequent actions under and modifications of that contract which resulted in a lowering of the price received by appellants vis-a-vis the price received by other producers who originally had the same contractual arrangements with Transcontinental.

not taken by Transcontinental. Cash settlement for volumes paid for but not taken was limited to the differential in price between the price in effect at the time the deficiency was incurred, and that price in effect at the time of taking. 3/ Transcontinental's rights to makeup deficiencies were lost at the termination of the contract. Transcontinental was also required to take all "casinghead gas" under both contracts (see, e.g., TXC-Transcontinental contract at 13).

The price provisions in both the Enstar and TXC contracts were identical as well, including an initial base price of $1.90 per Mcf, quarterly price escalations, the right to redetermine price subsequent to the effective date of deregulation, and annual price redeterminations thereafter. Both contracts provided for a primary term of 20 years from date of first delivery and year-to-year terms thereafter, subject to termination on any anniversary date of first delivery (see Enstar-Transcontinental contract at 17-22; TXC-Transcontinental contract at 17-22).

The terms of the Chevron-Transcontinental contract were similar with the exception of a few deviations in quantity, price, and term. Under the Chevron contract, Transcontinental was required to take or pay for a minimum average daily contract quantity of gas well gas equivalent to 80 percent of

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3/ This provision, by its terms, inured to the benefit of the "Seller," to the extent that the price of volumes when taken exceeded the price when volumes were initially paid for. Thus, the provision provided in pertinent part: "Any makeup gas well gas shall be taken without further payment, except for any differential in price between those in effect at the time the deficiency was incurred and that in effect at the time of taking."
Enstar-Transcontinental contract at 12-13; TXC-Transcontinental contract at 12-13.

Chevron's delivery capacity for the entire term (Chevron-Transcontinental contract at 9). Transcontinental's makeup period extended to 3 years initially, but was thereafter amended to reflect a 5-year makeup period (see Amendment to Chevron-Transcontinental contract, dated Nov. 13, 1978, at 1-2).

The Chevron-Transcontinental price provision was identical except that it provided for an initial base price of $2.25 per Mcf (see Chevron-Transcontinental contract at 17-21). The Chevron-Transcontinental contract was for a primary term of 5 years from the date of first delivery and year-to-year thereafter, subject to termination on any anniversary date of first delivery.

By letter agreement dated July 28, 1980, TXC, pursuant to a "Seller's Representative Agreement," designated Enstar as its representative for all purposes under its gas-purchase contract with Transcontinental "including, but not limited to, delivery, operation, allocation, accounting, and receipt and disbursements of payments to Seller under this agreement."

Pursuant to the provisions of the "Seller's Representative Agreement" and the course of dealings between the parties, Enstar disbursed royalty to MMS for the account of TXC until Enstar revoked said agreement with respect to the "receipt and disbursement of revenues only" (i.e. royalty) by letter dated January 4, 1984 (effective February 1, 1984). 4/

4/ In this letter, Enstar noted that "[a]s a result of TXP[O] accepting Transcontinental's Gas market out, Enstar has experienced excess royalty problems with the Minerals Management Service. * * * In order to avoid

At the time the contracts were entered into, all gas sold to Transcontinental under the respective contracts was required to be sold pursu-ant to section 102 of the Natural Gas Policy Act (NGPA), 15 U.S.C. § 3312 (1982), and royalty was tendered to MMS on the section 102 regulated price. 5/ The royalty payment procedure applicable during this period was set forth in a July 16, 1979, letter from MMS to Enstar, which is discussed in greater detail, infra.

Almost immediately upon deregulation of high-cost natural gas, Enstar sought to obtain deregulated section 107(c) prices for gas sold under its contract with Transcontinental. 6/ Section 107 approval, pursuant to applicable regulations (45 FR 28092, 28095-96 (Apr. 28, 1980)), permitted collection of the section 107 price retroactive to the date of a producer's application if the producer's contract so permitted. The Enstar price provisions provided that the effective date of a redetermined deregulated price would be the month following 60 days after Enstar made a written request to Transcontinental to renegotiate a deregulated price.

Enstar gave notice to Transcontinental, as required by its contract, on December 13, 1979. Thus, the earliest date under the contract that

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fn. 4 (continued)
further problems with MMS, Enstar hereby cancels the referenced Agreement for receipt and disbursement of revenues only, effective with February 1, 1984 deliveries."

5/ See 15 U.S.C. § 3331(b) (1982) and 44 FR 57726, 57739 (Oct. 5, 1979).

6/ High-cost natural gas, as defined by subsection 101(c)(1) through (4) of the NGPA, 15 U.S.C. § 3317(c)(1)-(4) (1982), was deregulated effective Nov. 1, 1979. On Dec. 13, 1979, Enstar filed an application for approval under section 107(c)(1) of the NGPA, 15 U.S.C. § 3317(c)(1) (1982). The application received final jurisdictional approval on Apr. 28, 1980.

Enstar could receive the section 107 deregulated price was March 1, 1980. The new deregulated price ($5.63), as determined by Enstar and Transcontinental pursuant to their contract, was based on a deregulated section 107(c) sale between Northern Natural Gas and Anadarko Production Company covering production from West Delta Blocks 137 and 138, OCS, Louisiana. 7/

Enstar and Transcontinental, in addition to redetermining the new deregulated price, amended the pricing provision to provide Transcontinental with the right to reduce the price if Transcontinental's average rolled-in gas cost at New York City exceeded the Btu equivalent cost of the lowest price No. 2 fuel oil. 8/ In the event that this occurred, Transcontinental acquired the right to nominate the highest marketable price for gas sold and

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7/ The pertinent portion of Article XI of the Enstar-Transcontinental contract provided:

"3. If at any time during the term of the contract the Federal Power Commission (or any successor governmental agency having jurisdiction over the rates charged for gas sold thereunder) ceases to have jurisdiction over the price of gas sold, ceases to exercise control over gas sold, or permits indefinite pricing provisions to become operative in a manner applicable under the contract, then, at Seller's request, the parties shall renegotiate the price at which natural gas is to be sold under the Contract. Any such request shall be made to Buyer in writing and may be made at any time following the effective date such deregulation or indefinite pricing provis-ions become operative, and subsequently at intervals not more than once each year. The renegotiated price shall take into account the highest effective price in any contract for bona-fide offer made by an interstate pipeline company of gas of comparable quality and quantity in the Federal Domain offshore Louisiana, under a contract containing comparable terms and conditions.

"4. The price so renegotiated shall become effective on the first day of the month following the expiration of sixty (60) days from the date of Seller's written request for such renegotiation. In no event shall the new price be lower than the price in effect prior to the time the price was renegotiated. The fixed quarterly periodic escalations provided for in the price schedule under the contract [1-1/2% annually] shall be applicable to any renegotiated price at the end of each one (1) quarter period following the date that any such renegotiated price becomes effective."

8/ See Letter dated July 10, 1980, from Transcontinental to Enstar at 1-7.

purchased on its system and, if the price paid to Enstar exceeded the former, Transcontinental could elect to notify Enstar that it would not pay the higher price and offer the highest marketable price for gas sold and purchased on its system as the new price under the contract. Under this provision Enstar would have 60 days to solicit offers from other purchasers. Transcontinental was permitted 30 days to match a higher bona fide offer and, if matched, the matched price constituted the new applicable price under the contract. If Transcontinental elected not to match, Transcontinental agreed to terminate the contract and provide transportation ashore for the sale of the affected gas to others. If no bona fide offers were received, Transcontinental's offer would be the new price payable by Transcontinental under the contract.

The amended pricing provision based on Transcontinental's rolled-in average cost in effect provided Transcontinental with a limited market-out provision. This must be distinguished from what is commonly referred to by appellants, Transcontinental, and MMS as a "market-out" or "economic-out" which permits a gas purchaser (e.g., Transcontinental) to reduce the price in light of current market conditions that render the gas at any particular point in time uneconomical. See Manual of Oil & Gas Terms, Williams and Meyers, 6th ed. (1984) at 265.

On July 1, 1980, TXC exercised its rights under the price provision of its contract to obtain a deregulated price of $6.397. The deregulated price was effective September 1, 1980. The deregulated price was based on the same third-party contract (between Anadarko Production Company and Northern

Natural Gas) which had been used by Enstar to establish its initial deregulated price under the Enstar-Transcontinental contract.

TXC and Transcontinental, in addition to redetermining the deregulated price, amended the price provision of their contract to incorporate Transcontinental's right to lower the price if Transcontinental's average rolled-in unit cost exceeded the Btu equivalent cost of the lowest price No. 2 fuel oil. The provision incorporated was identical to that incorporated by Transcontinental in the Enstar-Transcontinental contract, see note 7, supra.

By letter dated November 6, 1980, Chevron, the other nonaffiliated seller of gas from the lease, advised Transcontinental of its intention to redetermine the deregulated price. Chevron, therefore, did not obtain the deregulated section 107(c)(1) price until February 1981. 9/ The Chevron deregulated price was based on the TXC-Transcontinental sale price and, like the TXC price provision, allowed automatic quarterly escalations of 1.5 percent.

Effective February 1, 1981, the deregulated section 107(c)(1) price under the Chevron-Transcontinental contract was $6.5904 per MMBtu. 10/

9/ The letter agreement reflecting the redetermined deregulated price dated Jan. 26, 1981, was not executed by the parties until Sept. 30, 1981. The redetermined price was applied retroactively to Feb. 1, 1981.

10/ In connection with the deregulated price redetermination, all three contracts had been amended immediately preceding deregulation to provide for the metering and measuring of volumes and the calculation of price based on a Btu basis as opposed to an Mcf basis. Thus, all prices appearing hereafter in the text are on an MMBtu rather than Mcf base.

The Chevron-Transcontinental redetermination letter agreement also incorporated, as did the price redetermination agreements of TXC and Enstar, an amendment granting Transcontinental the right to reduce the price if Transcontinental's average rolled in unit cost at New York City exceeded the Btu equivalent of the lowest price No. 2 fuel oil.

In summation, by February 1, 1981, 100 percent of the working interest in OCS-G 1960 had taken action to obtain the higher section 107(c)(1) deregulated prices and all three producers had amended their contracts to grant Transcontinental the right to reduce the price received by them if Transcontinental's rolled in average unit cost exceeded the lowest price paid for No. 2 fuel oil.

Thereafter, by written notice dated July 1, 1981, TXC exercised its right to renegotiate the price again, pursuant to the annual price redetermination provision of its contract with Transcontinental. On March 8, 1982, the parties agreed that the new deregulated price would be $8.496 MMBtu, based on a sale between Tennessee Gas Pipeline and Columbia Gas Transmission Corporation and Chevron USA, Inc., covering South Pass Block 78 OCS, Louisiana. This new price was made effective as of September 1, 1981. 11/

Soon after this agreement was reached, however, TXC agreed to reduce the price payable by Transcontinental to $5.00 per MMBtu. TXC's actions

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11/ Pursuant to Article XI(3) and (4) of the TXC-Transcontinental contract this price increase was effective Sept. 1, 1981. See Letter-agreement dated Feb. 17, 1982, from Senior Vice President, Gas Supply, Transcontinental, to Vice President and Associate General Counsel, TXP.

were taken in response to a letter from Transcontinental, dated June 1, 1982, in which Transcontinental described various marketing problems it was experiencing. Transcontinental's letter advised that it had given notice to sellers, under those section 107 gas purchase contracts which contained "market-out" provisions, that the new (reduced) price to be paid would be $5.00 per MMBtu (inclusive of tax reimbursement and all other adjustments and escalators).

As noted above, the TXC-Transcontinental contract did not contain such a general market-out provision. Nonetheless, Transcontinental requested that TXC voluntarily agree to reduce the price for its production. 12/ By letter dated June 2, 1982, TXC agreed.

12/ Transcontinental's June 1, 1982, letter stated, in pertinent part:

"[Transcontinental] is also requesting Sellers under those Section 107 gas purchase contracts which do not contain market-out provisions to voluntarily reduce deliveries and associated potential take-or-pay obligations by 25% from current levels. However, the result from these actions is not expected to bring TGPL's market problems to a completely manageable level. In order to assist in preventing the anticipated erosion of the industrial market and to preserve to the maximum extent possible a long term market for TXC's deep gas reserves, we are asking TXC to consider reducing, hopefully on a temporary basis, the price to be paid by TGPL for deregulated gas purchases under the above referenced contract(s) to 5.00 per MMBtu (inclusive of tax reimbursement and all other adjustments and escalators). This request is subject to receipt by TGPL of the requisite consent from the Trustee under the Mortgage and Deed of Trust dated May 15, 1949, between TGPL and the Chase Manhattan Bank (N.A.) and C.F. Ruge. Should you give favorable consideration to our request, we propose that this price reduction be made effective retroactively to May 1, 1982, the date the majority of the market-out reductions were made effective.

"While it is impossible to estimate with precision the future course of fuel oil prices and the resultant effect on the industrial market, it is quite possible that the current depressed level of prices is only a short term condition. We, therefore, propose that the $5.00 price level, if agreed to by TXC, would be reviewed by TXC and TGPL on a periodic basis to monitor competitive conditions in order to permit a return to the applicable contract price level at the earliest time market conditions would permit.

"While we recognize that you are not contractually required to agree with our request, your favorable consideration would be greatly

Between August 1982 and May 1983, Enstar, as Operator and pursuant to TXC's request, paid royalties to MMS on the reduced value ($5.00 per MMBtu) for TXC's account. We note, by way of comparison, that during the last quarter of 1982, Enstar pursuant to its contract with Transcontinental, received and paid royalty at the rate of $9.325 per MMBtu.

Thereafter, on May 31, 1983, TXC again voluntarily agreed to a fur-ther reduction in the price payable by Transcontinental to $4.00 per MMBtu, effective as of May 1, 1983. 13/ This letter agreement expressly noted:

> TGPL [Transcontinental] recognizes that the possibility exists that TXC may be required to pay royalty based upon the deregu-lated price otherwise provided for in the Subject Contracts rather than the $4.00 per MMBtu price established hereunder. Therefore, in exchange for TXC's agreement to forego revenues otherwise legitimately available to it, TGPL agrees that the "excess royalty" provision contained in Section 5. of Article XI of the Vermilion Area, Block 25 Field gas purchase contract, and Section 6 of Article XI of the South Timbalier Area, Block 148 Field gas purchase contract, [14/] shall apply with full force and effect to gas purchased at the prices established hereunder. [Emphasis supplied.]

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fn. 12 (continued)
appreciated. In addition to considering the market situation discussed above, you should also be aware of the recent Notice of Inquiry issued April 28, 1982 by the Federal Energy Regulatory Commission in Docket No. RM82-26 to investigate whether serious economic distortions may be evolv-ing in the nation's natural gas markets and to examine its authority to take corrective action. The Commission notes that allegations have been made that various provisions in producer gas contracts, such as price escalation and take-or-pay clauses, may cause market disorders. Based on the record developed in the proceeding, the Commission will determine whether to initiate a Notice of Proposed Rulemaking and/or make recommendations to Congress. TGPL believes that it is desirable for the industry to take responsible corrective action on a voluntary basis rather than face legislative or administrative action which could unduly and perhaps unrealistically restrict industry practices."

13/ See Letter-agreement dated May 16, 1983, from Transcontinental to TXC, approved by TXC on May 31, 1983.

14/ The Excess Royalty provision (Article XI(6)) contained in appellants' original contract provided:

Between May 1 and November 1, 1983, Enstar, on behalf of appellants, received from Transcontinental and disbursed royalties on the basis of the reduced value of $4.00 per MMBtu. During the same second quarter of 1983, by contrast, the price payable by Transcontinental to Enstar for its own account continued to escalate from $10.097 to $10.248 per MMBtu. Enstar duly tendered royalty to MMS on these higher values for its own account. Chevron, during the same period, received $10.097 per MMBtu and similarly paid royalties on this higher value basis.

On July 12, 1983, only 2 months after the price reduction to $4.00 per MMBtu, TXC and Transcontinental further amended their outstanding contracts, effective January 1, 1984. Under this amendment, Transcontinental's obligation to take or pay for a daily contractual minimum equivalent to 90 percent of TXC's delivery capacity was changed to require that Transcontinental take or pay for not more than an average daily contract minimum quantity equal to TXC's proportionate share of Transcontinental's market. See "Amendment to Gas Purchase Contract," executed

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fn. 14 (continued)

"6. Buyer agrees, subject to Seller obtaining any necessary authorization from the Federal Power Commission, to reimburse Seller for all "excess royalty payments" which Seller may be required to pay (or which Seller demonstrates to the satisfaction of Buyer that there is reasonable probability that it may be required to so pay) to any royalty owner (but not overriding royalty interests created during the term hereof) with respect to gas delivered to Buyer hereunder, as such royalty interest is in effect at the date of execution of this agreement under Seller's lease(s) on the acreage described in Exhibit "A" hereof. "Excess royalty payment" as used herein is defined as the amount by which royalty payments under Seller's lease(s) on the acreage described in Exhibit "A" hereof, exceed the amount such payments would have been if made at the prices received by Seller under the terms of this agreement. In the event demand is made on Seller by any royalty owner for settlement of royalty payments on any amount in excess of the prices received by Seller under the terms of this agreement, Seller shall notify Buyer of such demand as soon as is practicable."

July 12 and 13, 1982 (General amendment). 15/ The amended take or pay obligation provision was not limited to periods of market erosion but rather was effective from January 1, 1984, through termination of the contract. Id.

Transcontinental's makeup rights for gas paid for but not taken were substantially broadened to include cash settlement makeup. The General amendment permitted Transcontinental to obtain a cash settlement for volumes initially paid for but not taken if Transcontinental had not recovered volumes within 5 years of date of occurrence, with interest. Id. TXC also released and discharged Transcontinental from any and all claims attributable to obligations of Transcontinental under those contracts to take or pay for gas tendered for delivery prior to January 1, 1984, or the date of first delivery, whichever was later. Thus, in effect, TXC waived any rights that it had to enforce Transcontinental's take or pay obligations retroactive to the date of first delivery through termination of the contract.

By another amendment of the same date, TXC and Transcontinental amended the gas purchase contract for lease OCS-G 1960 to provide for a market-out or economic-out provision inuring to Transcontinental's benefit. This market-out provision provided that, notwithstanding anything to the

15/ As noted in the text, this amendment affected a number of existing contracts between TXC and Transcontinental. On the same date, however, an additional amendment was agreed to by TXC and Transcontinental. This amendment affected only the TXC-Transcontinental contract for gas produced from OCS-G 1960. In order to differentiate between these two amendments, we shall refer to the first amendment as the General amendment and the second one as the contract amendment.

contrary in the TXC-Transcontinental contract, the price paid by Transcontinental shall never exceed a price which, in Transcontinental's "sole opinion, will render the gas uneconomic to [Transcontinental] or its customers." This amendment further provided that, if Transcontinental should exercise its market-out authority, TXC could terminate the agreement only to the extent that it could obtain a higher price for the gas from a third party. The purported consideration for the contract amendment consisted of Transcontinental's agreement to purchase TXC's gas reserves located at Eugene Island Area Block 46 Field, West Cameron Area Block 215 Field, High Island Area Block A-438 Field, and High Island Area, South Addition, Block A-552 Field on unspecified terms.

On September 27, 1983, 4 months after the amendment of the TXC-Transcontinental contract to provide for the market-out provision, Transcontinental exercised its right to market-out. Transcontinental nominated a base market-out price of $2.80 per MMBtu (inclusive of all tax reimbursement and, without limitation, any and all other adjustments and escalators). See Letter dated Sept. 27, 1983, from Transcontinental to TXC. Transcontinental offered pricing alternatives of $3.10 and $3.40 per MMBtu, to the extent that purchasers elected to waive past and future take or pay requirements accrued under the subject contracts (the market-out letter applied to a list of contracts which included the one at issue). Appel- lants elected to accept the second pricing alternative on October 15, 1983, which provided inter alia:

> [F]or those producer-suppliers with two or more existing con-tracts for the sale of gas to Transco (at least one of which does not contain a "market out" provision), we will agree to a

> maximum price of $3.40 per MMBtu (inclusive of tax reimbursement, and without limitation, any and all other adjust-ments and escalators) for all gas delivered under the subject contract, effective November 1, 1983, in consideration for your agreement to release Transco from any past take or pay or minimum take requirements accrued under all gas purchase contracts between you and Transco and release Transco from any additional requirements that may accrue for the time period that the $3.40 price remains in effect.

Id.

By accepting this second pricing alternative, appellants waived Transcontinental's obligation pursuant to the amended contract to take the average daily contract minimum quantity equivalent to TXC's proportionate share of Transcontinental's market and waived minimum take requirements and associated take or pay obligations under all contracts it had with Transcontinental. As noted above, TXC had previously essentially waived Transcontinental's take or pay obligations with respect to the instant contract in the July 1983 General amendment. Consequently, effective November 1, 1983, appellants, pursuant to the amended TXC-Transcontinental gas purchase agreement, received $3.40 per MMBtu and royalty was paid on this value to MMS.

During the period from August 1982 through September 1983, there is no evidence in the record that either Enstar or Chevron voluntarily assented to reduce the prices obtained under their contracts. Nor is there any indication that, during this period, Transcontinental attempted to exercise its right to reduce the cost of gas under the Chevron or Enstar contracts on the basis that the average rolled in unit cost for gas exceeded the lowest price paid for No. 2 fuel oil. Rather, the record reflects that Chevron and Enstar consistently, through annual price redetermination and quarterly price escalations, renegotiated and obtained higher prices during the August 1982 through September 1983 period.

By memorandum dated October 6, 1983, the Chief, Royalty Valuation and Standards Division (RVSD), advised the Regional Manager, Houston Regional Compliance Office (Manager), that the royalty base for appellants' gas should not be less than the value negotiated between Enstar and Transcontinental.

By letter dated October 31, 1983, the Manager advised Enstar, as operator, that the royalties paid on behalf of appellants for gas production under OCS-G 1960 "are probably understated." The Manager's letter advised, inter alia, that if Enstar had "any additional data or information that will demonstrate that the prices on which royalty payments attributable to TXC's production fulfill the requirements of 30 CFR 250.64, you must submit the additional data to Houston Regional Compliance Office within 15 days from receipt of this letter * * *."

Enstar transmitted a copy of the letter to appellants and immediately advised the Manager that it would forward any justification supplied by appellants in support of the challenged royalty valuation practice. No response from TXC was forthcoming nor did the Manager receive any further information before he issued the November 14, 1983, demand letter to Enstar.

In this letter, the Manager determined that royalties had been underpaid in the amount of $1,251,317.07, and he directed Enstar to remit the same on behalf of TXC. The amount of royalties deemed owing was calculated based on the prices received by Enstar pursuant to its contract with Transcontinental. A copy of this letter was transmitted to TXC, which subsequently tendered the amount in question, together with $164,767.02 in accrued interest, under protest.

On December 5, 1983, TXC, on behalf of itself and TXPO, appealed the decision of the Regional Manager to the Director of MMS, pursuant to 30 CFR 290.3(a). Appellants filed a motion to vacate and, alternatively, a brief on the merits. Their motion to vacate was based on alleged procedural deficiencies which they asserted had occurred below. By order dated December 12, 1984, the Director, MMS, denied the motion to vacate.

In his December 12 order, the Director held that, contrary to appellants' assertions, the administrative procedures provided in 30 CFR 250.70 (Investigations) through 30 CFR 250.80 (Remedies and Penalties) (1987) 16/ were inapplicable absent the imposition of civil penalties. The Director

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16/ Subsequent to the filing of this appeal, the regulations appearing at 30 CFR 250.70 through 250.80 (1987) were amended on Apr. 1, 1988. See 53 FR 10596. Thus, 30 CFR Subpart 250.70 (1987) (Investigations) was deleted on the ground that it contained "MMS internal procedures that are inappropriate as regulatory provisions." 51 FR 9338 (Mar. 18, 1986) (Proposed Rule). At the same time, 30 CFR Subpart 250.80 (1987) (Remedies and Penalties) was revised, redesignated as Subpart N and recodified at 30 CFR 250.200 (1988). For the sake of clarity, however, and because these regulations were in effect when the appeal arose, we shall refer to the regulations in question as 30 CFR 250.70 through 250.80 (1987) throughout the text.

further concluded that appellants had suffered no prejudice in the proceedings below and that their due process rights were fully protected since they had the opportunity to be heard through the filing of documentary evidence and affidavits before RVSD as well as before the Director. The Director also noted that appellants' rights were further safeguarded by the possibility of review by this Board.

With respect to the substantive royalty valuation issue, the Director granted appellants an additional 21 days in which to file any further written documentary evidence, including evidence concerning the fair market value of the production during the relevant period, evidence of posted prices, and other relevant matters to be considered in determining "value" under the lease and regulations (see 30 CFR 206.150). Appellants likewise were invited to submit for the record all amendments to gas purchase contracts with Transcontinental and requests for new value redetermination letters which may have been filed by them or on their behalf with the Geological Survey (Survey) based on such contract amendments. Thereafter, appellants filed an extensive memorandum, copies of contract amendments, and evidence of market conditions between August 1982 through September 1983. On July 16, 1985, RVSD submitted a report in response to these submissions and appellants subsequently filed a reply to this report.

By decision dated April 18, 1986, the Director, MMS, determined that the prices which Enstar received were properly determined to be the royalty value of appellants' production under the lease during the relevant periods. Accordingly, he affirmed the decision of the Manager requiring the payment of $1,416,084.09, representing additional royalties and accrued interest. TXC and TXPO thereupon pursued an appeal to this Board.

With respect to the instant appeal, we note that, in addition to challenging the substantive correctness of the MMS decision, appellants reiterate their claim that the procedures utilized below violated their due process rights. We will deal with these contentions first.

Appellants maintain that MMS was bound to follow the procedures set forth in 30 CFR 250.70 through 30 CFR 250.80 (1987) and failed to do so in this case. Based on their assertion that the Department has violated its own regulations, appellants contend that, under the principles exemplified by United States ex rel. Accardi v. Shaughnessy, 347 U.S. 260 (1954), the decisions below must be vacated. Appellants argue further that they have been denied procedural due process because the Director made no attempt to identify which "rules of practice" did apply to the Manager's order. Finally, appellants contend that notice to Enstar was not equivalent to notice to appellants. See generally Statement of Reasons (SOR) at 11-26; Supplemental Statement of Reasons (Supp. SOR) at 37-52.

In response to appellants' procedural arguments, MMS asserts that the Manager complied with all applicable rules and regulations of the Department of the Interior. More specifically, MMS contends that the procedures provided by 30 CFR 250.70 through 30 CFR 250.80 (1987) are not applicable to the Manager's order or the conduct of MMS staff preliminary to this order absent the imposition of civil penalties. MMS asserts that, except for the general regulations set forth in 30 CFR 243.2 and 30 CFR Part 290, there are no regulations specifically prescribing procedures for issuance of an order relating to nonpayment or underpayment of royalties, and no such regulations existed at the time of issuance of the demand letter by the Regional Manager. Rather, MMS states that its practice is purely informal with respect to such questions. MMS concludes that the decision below is not open to challenge for failure to follow any specified regulatory requirements except for those set forth in 30 CFR 243.2 and 30 CFR Part 290. See MMS Answer (Answer) at 36-47.

In any event, MMS suggests that the real question is not whether the specific procedures outlined in 30 CFR 250.70 through 250.80 (1987) were followed but whether appellants were afforded the opportunity to present their evidence and arguments to an impartial decision-maker. In other words, did appellants receive the process which was due? In this regard, MMS notes that appellants were given ample opportunity to review MMS preliminary findings, submit information before the final order was issued, and file extensive briefs on appeal to the Director. Moreover, appellants were then permitted, pursuant to Departmental regulations, to appeal from the Director's adverse decision to this Board. Thus, MMS argues, the Department has provided appellants with the fair hearing before an impartial body mandated by due process considerations.

[1] Appellants contend that the Department was required to follow the regulations set forth at 30 CFR 250.70 through 250.80 (1987) as a precondition for the assessment of underpaid royalties. We do not agree. On the

contrary, we believe that a review of both the language of the regulations as well as the explanatory comments which accompanied the adoption of these regulations leads ineluctably to the conclusion that these regulations only apply where the question at issue is the assessment of civil penalties.

The regulations at issue were promulgated in 1979. Until that time, the regulations at 30 CFR 250.80 17/ governed "Procedure in the Case of Default by Lessee" and provided procedures for implementing sec-tion 5(a)(2) and 5(b)(1) and (2) of OCSLA, 43 U.S.C. § 1334(a)(2), (b)(1), and (b)(2) (1976). Prior to the adoption of the Outer Continental Shelf Lands Act Amendments of 1978 (OCSLA Amendments Act), 92 Stat. 629, these sections provided authority for the assessment of criminal penalties (section 5(a)(2)), the administrative cancellation of a non-producing lease where a default under the lease continued for a period of 30 days after the mailing of notice to the lease owner (section 5(b)(1)), or the judicial cancellation of a producing lease (section 5(b)(2)). 18/

17/ There were no regulations at 30 CFR 250.70 prior to the 1979 amendments.

18/ Appellants' assertion that this regulation was a broad "default" provision, embracing any alleged underpayment of royalties and not necessarily premised on any specific statutory penalty provision, does not withstand analysis. Appellants contend that 30 CFR 250.80 (1970) afforded the supervisor authority to recommend (a) cancellation, (b) a penalty, or (c) "the exercise of such other legal or equitable remedy as the lessor may have" (Supp. SOR at 38). The regulation, however, provided, in relevant part:

"Whenever the owner of a lease fails to comply with the provisions of the regulations in this part, the supervisor is authorized to give 30-day notice of such default by registered letter to the lessee at his record post office address as provided in section 5(b)(1) of the act and to recommend to the Secretary through the Director * * * the exercise of such other legal or equitable remedy as the lessor may have." 30 CFR 250.80 (1970) (emphasis supplied).

This regulation was, thus, expressly grounded in 43 U.S.C. § 1334 (1976). Moreover, by its terms, this regulation was not directory but merely "authorized" the Supervisor to give the notice required by 43 U.S.C.

In 1978, however, Congress adopted the OCSLA Amendments Act. Section 209 of this Act added a number of new sections to the original OCSLA, including, inter alia, a new section 24 entitled "Remedies and Penalties." This section is now codified as 43 U.S.C. § 1350 (1982). Section 24 provided for increased criminal penalties, made such criminal penalties applicable to corporate officers and agents who "knowingly and willfully authorized, ordered, or carried out the proscribed activity," and autho-rized the institution of civil action in United States District Courts for the purpose of obtaining injunctive relief in certain circumstances. And, of particular relevance herein, section 24(b) granted authority for the assessment of civil penalties. Section 24(b), 30 U.S.C. § 1350(b) (1982), provides:

> If any person fails to comply with any provision of this subchapter, or any term of a lease, license, or permit issued pursuant to this subchapter, or any regulation or order issued under this subchapter, after notice of such failure and expiration of any reasonable period allowed for corrective action, such person shall be liable for a civil penalty of not more than $10,000 for each day of the continuance of such failure. The Secretary may assess, collect, and compromise any such penalty. No penalty shall be assessed until the person charged with a violation has been given an opportunity for a hearing. [Emphasis supplied.]

In explaining the import of this provision, H.R. Rep. No. 590 noted that "[s]ubsection 24(b) provides for a civil penalty to be assessed

against any person, who after notice, a reasonable period for corrective

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fn. 18 (continued)
§ 1334(b)(1) (1976). It in no wise purported to establish a comprehensive procedure applicable, as appellants would have it, to any request for the payment of additional royalties. See, e.g., The Superior Oil Co., 12 IBLA 212 (1973).

action, and a hearing, continues to fail to comply with the Act, any regulation or order under it, or the terms of an OCS lease, license or permit." H.R. Rep. No. 590, 95th Cong., 2d Sess. 163, reprinted in 1978 U.S. Code Cong. & Admin. News at 1569. It seems clear beyond cavil that this statute does not, by its terms, apply to a situation, such as that involved in the instant appeal, where a lessee has been informed that additional royalties are due and owing and the lessee, or his agent, timely complies with the order and submits the money demanded.

Appellants, in fact, do not contend that they are liable for a civil penalty under 43 U.S.C. § 1350 (1982). Rather, they argue that the procedures set forth at 30 CFR 250.80 (1987) are applicable when the Department determines that an underpayment in royalty has occurred, even if the Department is not seeking civil penalties. The difficulty with appellants' position is that the regulations in question were clearly adopted to implement the civil penalties provision of 43 U.S.C. § 1350 (1982).

Thus, in proposing the regulations which eventually became 30 CFR Subpart 250.80, the Department noted that "[t]he most significant changes proposed for Part 250 are (1) the substitution of a new 'Remedies and Penalties' section to incorporate the civil penalties requirements of section 24 of the OCS Lands Act, as amended * * *." 44 FR 13527-28 (Mar. 12, 1979). Subsequently, it was noted that "[section 250.80] has been added to implement the provisions of section 24 of the Act." 44 FR 13529. In adopting these regulations, the Department noted that "[t]he more important changes are: (1) The establishment of a 'Remedies and Penalties' procedure which implements the civil penalty requirements of section 24 of the Act * * *." 44 FR 61886 (Oct. 26, 1979). The clearly manifested intent of the Department was to establish procedures for the implementation of the civil penalty assessment authority with which it had been provided by the OCSLA Amendments Act.

This intent is reflected in the regulation, as well. Thus, 30 CFR 250.80-1(a)(1) (1987) provides for the appointment of Reviewing Officers by the Director, MMS. The remaining portions of 30 CFR 250.80-1 address the actions of the Reviewing Officer in deciding cases and provide for a review of the Reviewing Officer's decision by the Director, MMS. Not only is the remainder of this regulation clearly focussed on the procedures to be followed in determining whether a civil penalty will be assessed, but the regulations expressly define "Reviewing Officer," as "an employee of the Minerals Management Service who is delegated the authority to assess civil penalties and, when appropriate, to recommend the initiation of criminal proceedings." 30 CFR 250.2(nn) (1987).

We hold, therefore, that the procedures delineated by 30 CFR 250.80 (1987) are applicable only in those cases involving the assessment of a civil penalty. The ascertainment of the value of gas for royalty purposes does not invoke these procedures unless the lessee refuses to comply with an order of MMS to tender increased royalty and MMS thereafter attempts to assess a civil penalty for this refusal to comply with its order. This, indeed, is essentially what occurred in Marathon Oil Co. v. MMS, 106 IBLA 104, 95 I.D. 265 (1988), appeal filed, Civ. No. A89-064 (D. Alaska Mar. 1, 1989). 19/ Appellants' contention that we should set aside the decision of the Director, MMS, because of a failure to comply with the procedures set forth at 30 CFR 250.80 (1987), must be rejected for the simple reason that those procedures are inapplicable to the case on appeal. See also Marathon Oil Co., 90 IBLA 236, 93 I.D. 6 (1986).

Appellants' complaint with respect to the failure of the Director, MMS, to specify which rules of practice were applicable essentially goes to the actions of the Regional Manager preparatory to the initial issuance of the November 14, 1983, demand letter to Enstar, as Operator, directing the payment of $1,251,317.97 in additional royalties due from production attributable to TXC's 15-percent interest in the lease. Intertwined with this general argument is the contention that the prior notice sent to Enstar requesting further information relative to the valuation of the gas

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19/ Marathon Oil Co. v. MMS, supra, involved the assessment of a civil penalty under section 109(c) of the Federal Oil and Gas Royalty Management Act of 1982 (FOGRMA), 30 U.S.C. § 1719(c) (1982), for the knowing and willful failure of appellant to pay royalty on certain uplands oil and gas leases. Section 109 of FOGRMA expressly provides that, except for certain situations such as the knowing and willful failure to make any royalty payments by the date specified in the lease, if the lessee, after due notice, corrects the violation within 20 days or such longer period as the Secretary agrees to, there will be no assessment of a civil penalty. See 30 U.S.C. § 1719(a)(1)(B) (1982). It also requires that a hearing be held before the assessment of any civil penalty. 30 U.S.C. § 1719(e) (1982).

While the issues confronted by the Board in its adjudication of Marathon's appeal were related to the assessment of civil penalties, an earlier appeal within MMS had involved the question of the proper basis of computation of the value of certain gas produced and ultimately sold in the form of liquified natural gas. The question of valuation was determined through the general appeal structure provided by 30 CFR Subpart 290. After it was determined by the Assistant Secretary that Marathon had undervalued its gas for royalty purposes and Marathon continued to refuse to submit the monies deemed to be owing, the Director, MMS, commenced the procedures set forth at 30 CFR 241.51 to assess a civil penalty. See Marathon Oil Co. v. MMS, supra at 114-19, 95 I.D. at 271-74.

for royalty purposes was not adequate notice to TXC. Appellants assert that the failure of the Department to establish applicable procedures outlining the steps which would be taken prior to issuance of the demand letter adversely affected their due process rights.

[2] On this point, we must reject appellants' contention that service on Enstar of the Regional Manager's October 31, 1983, letter advising it that the appellants' royalties were probably understated and soliciting any further data which might support the valuation of TXC's production, did not constitute service on appellants. As noted above, TXC had entered into an agreement with Enstar on July 28, 1980, designating Enstar as TXC's representative for all purposes under TXC's gas purchase contract with Transcontinental. While this agreement, by its terms, relates to the "delivery, operation, allocation, accounting, and receipt and disbursement of payments" to TXC under the TXC-Transcontinental contract, it is clear that included within the ambit of this agreement was the responsibility of Enstar to tender to the Government the royalty payments due from TXC's share of the production. 20/ Accordingly, with respect to questions relating to the determination of the amount of royalty due from TXC, Enstar was properly deemed to be TXC's agent. Thus, service on Enstar was, in law, constructive service upon TXC. Accord, United States v. Mine Development

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20/ Thus, during the 1982 through 1983 period, appellants affirmatively directed Enstar to pay its royalties on the basis of $5.00 per MMBtu. See Letters dated Sept. 23, 1982, from Elmer L. Hitt, Acting Supervisor, Gas Marketing, for TXC and Sept. 27, 1982, from Cyndi Becker, Director, Revenue Accounting, for TXC. At no time did appellants contest Enstar's authority to act as appellants' agent until Enstar cancelled the Seller's Representative Agreement on Jan. 4, 1984 (see note 4, supra).

Corp., 27 IBLA 238 (1976) (service on attorney of record constitutes effective service on the attorney's client).

[3] More problematic, however, is appellants' assertion that the failure of the Department to provide rules prescribing procedures to be followed prior to issuance of an order requiring payment of increased royalties adversely affected appellants' substantive rights. Thus, appellants note that once the Regional Manager had determined that they owed additional royalties and demanded that these monies be remitted, appellants were faced with unpalatable choices. They could pay the monies under protest, as they did. The problem with this course of action is that, even if they were ultimately to prevail in their assertion that no additional royalties were owed, they would suffer the economic loss attendant upon the loss of use (interest) of the funds which they had paid under protest. On the other hand, if they refused to pay in compliance with the Regional Manager's instructions, they would make themselves liable for the assessment of civil penalties and possibly cancellation of the lease under 43 U.S.C. § 1350 (1982). Thus, appellants conclude, the mere issuance of the decision of the Regional Manager, prior to their being afforded an opportunity to be heard, violated their rights to due process protected by the Constitution.

There are, however, a number of difficulties with appellants' analysis. First of all, as we have indicated above, service of the October 31, 1983, letter on Enstar was constructive service upon appellants. Thus, they were afforded an opportunity to be heard prior to the issuance of the demand letter on November 14, 1983. 21/

Second, the law is well settled that due process does not require notice and an opportunity to be heard prior to the initial decision in every case where a person may be deprived of an asserted right so long as the individual is given notice and an opportunity to be heard before the initial decision becomes final. Citizens for the Preservation of Knox County, 81 IBLA 209, 219 (1984); Francis Skaw, 63 IBLA 235, 239 (1982); Dorothy Smith, 44 IBLA 25, 28-29 (1979). Thus, insofar as the determination of value of the gas produced is concerned, appellants' due process rights were more than adequately protected by the right of appeal to the Director, MMS, and subsequently to this Board. Dorothy Smith, supra. Appellants argue, however, that, to the extent they were required to tender the money during the pendency of the appeal, they have suffered an injury since they have lost the use of that money, even if they ultimately succeed in their appeal.

21/ Appellants correctly point out that, while the Oct. 31 letter gave Enstar 15 days from receipt of the letter in which to submit any addi-tional data that would demonstrate that "the prices on which royalty payments attributable to TXC's production fulfill the requirements of 30 CFR 250.64," the demand letter of the Regional Manager was issued only 13 days after Enstar received the initial letter. While this action may well be deemed premature, appellants have failed to establish how they have been adversely affected by the failure of the Regional Director to wait the full 15 days. Thus, Enstar promptly responded to this inquiry and sent the Regional Manager copies of its correspondence with TXC regarding this issue. And the record establishes that these documents were reviewed prior to the issuance of the Nov. 14, 1983, order. In the absence of any indication that further justification would be forthcoming, it seems entirely reasonable for the Regional Manager to proceed to issue the demand letter on Nov. 14. In point of fact, appellants submitted nothing to the Regional Manager until Dec. 5, 1983. Thus, even if issuance of the demand letter could be adjudged premature, appellants can show no prejudice from this action.

The fact of the matter, however, is that appellants could have refused to tender the money. It is true, as indicated above, that such a course of action might have made them liable to the assessment of civil penalties. 43 U.S.C. § 1350(b) (1982). But, such a contingency could only occur if it were ultimately decided that appellants' substantive arguments must be rejected. We recognize that a company in appellants' situation might be reluctant to expose itself to this increased liability. But this reluctance does not alter the fact that the option still exists. That appellants ultimately decided to forego such a risk does not render their choice any less real.

Moreover, there was another option arguably available to appellants. Appellants note that they requested a suspension of the requirement that they submit the money deemed owing, expressing their willingness to post an interest-bearing bond, but that their request was denied (see Supp. SOR at 6). Appellants did not seek a review of the denial of their suspension request before this Board, but rather thereupon paid both the royalty and accrued interest under protest. However, had they, in fact, pursued an appeal before the Board, it seems reasonably clear that they would have prevailed.

Thus, in Marathon Oil Co., 90 IBLA 236, 93 I.D. 6 (1986), the Board reversed a decision of the Director, MMS, refusing to permit the appellant therein to post a bond in lieu of submitting the additional royalties deemed due. In Marathon, the Board adopted the analysis of the court in Placid Oil Co. v. United States Department of the Interior, 491 F. Supp.

895 (N.D. Texas 1980), that the threat of lost interest on monies tendered in response to an order to pay additional royalties constituted the threat of irreparable injury, since, even if the lessee were successful, the interest could not be recovered. Accordingly, the Board held in Marathon that the decision of the Director, MMS, refusing to allow Marathon to post a bond in lieu of tendering the amount of royalties deemed outstanding, could not be sustained.

Admittedly, the regulation applied in Marathon, 30 CFR 243.2, was not adopted until September 21, 1984, over 9 months after appellants had filed their appeal with the Director, MMS. However, the regulation, as adopted, was expressly made retroactive to August 12, 1983, and would thus have applied in the adjudication of any appeal to this Board (see 30 CFR 243.2). In any event, even in the absence of a specific regulation authorizing the submission of a bond, 22/ the decision of the Board in Marathon makes it abundantly clear that the refusal of the Director, MMS, to permit the posting of a bond would constitute the infliction of irreparable injury should appellants ultimately prevail in their appeal. It could, therefore, be expected that had appellants filed an appeal from a denial of their request

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22/ And, in this regard, we would point out that there had been a prior regulation, 30 CFR 250.81 (1979), which expressly authorized the submission of a bond in cases involving OCS oil and gas leases as well as an existing regulation, 43 CFR 3165.4 (1983), with respect to uplands oil and gas leases which also authorized the submission of a bond. It seems reason-ably clear that the omission of the language authorizing the submission of a bond occurred inadvertently during the promulgation of general revisions in 1979. Compare Proposed regulation 30 CFR 250.81, 44 FR 13542 (Mar. 12, 1979), with Final regulation 30 CFR 250.81, 44 FR 61907 (Oct. 26, 1979), particularly in light of the Preamble to the Final Regulation which noted that "[t]he changes made in § 250.80 are primarily organizational in nature and have been made to clarify the provisions." 44 FR 61892.

that they be permitted to post a bond, the appeal would have received favorable consideration by the Board.

But, as noted above, appellants chose not to appeal to this Board. Nor did they elect to seek injunctive relief in the Federal Courts. See, e.g., Placid Oil Co. v. U.S. Department of the Interior, supra; Conoco, Inc. v. Watt, 559 F. Supp. 627 (E.D. La. 1982). Rather, they submitted the royalty payments as directed. By doing so, they effectively waived the objection to the requirement that they submit the past royalties and accrued interest during the pendency of the appeal.

Ultimately, of course, appellants will have suffered injury by the failure of the Director, MMS, to permit them to post a bond only if they prevail on the substance of their appeal, since, if the decision of the Director is determined to be correct, they have suffered no injury by being required to tender the past royalties during the pendency of the appeal. It is to these substantive issues which we now turn our attention.

With respect to the substantive facets of the Director's decision, appellants make numerous arguments. Initially, they contend that MMS is bound by the Oil and Gas Supervisor's royalty payment instructions con-tained in his July 16, 1979, letter since that letter has never been revoked. They argue that they have accounted for their share of the production at the price paid by Transcontinental under its contract with appellants in accord with these instructions.

[4] The July 16, 1979, instructions from the Oil and Gas Supervisor, Accounting, Gulf of Mexico, to Enstar required that royalty payments be computed "based on the lease delivery volumes times the applicable FERC-approved sales price, or higher price if received." Appellants argue that their payments have been made in compliance therewith and that the Regional Manager lacks authority to retroactively alter this determination of value.

The problem with appellants' analysis is that, at the time that the letter was issued to Enstar, the gas being produced was section 102 gas, 15 U.S.C. § 3312 (1982), the price for which was controlled by FERC. Effective November 1, 1979, high-cost natural gas, as defined by section 107(c) of the NGPA, 15 U.S.C. § 3317(c) (1982), became deregulated. 23/ On October 29, 1979, interim regulations were published providing, inter alia, for procedures by which gas producers could obtain a final eligibil-ity determination that their gas qualified under the Act. See 44 FR 61950. Final rules were thereafter promulgated on April 28, 1980. See 45 FR 28092. Pursuant thereto, the gas produced from lease OCS-G 1960 was determined to be high-cost gas, within the meaning of section 107 of the NGPA, and accordingly was no longer subject to FERC-approved sales prices.

As the result of this action, the letter of the Oil and Gas Supervisor ceased to have any legitimate bearing with respect to the valuation of

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23/ Section 121(b) of the NGPA, 15 U.S.C. § 3331(b) (1982), provided that: "[E]ffective beginning on the effective date of the incremental pricing rule required under section 3341 of this title, the provisions of part A of this subchapter respecting the maximum lawful price for the first sale of natural gas shall cease to apply to the first sale of high-cost natural gas which is described in section 3317(c)(1), (2), (3), or (4) of this title."
The incremental pricing rule became effective on Nov. 1, 1979. See 44 FR 61951 (Oct. 29, 1979).

production under this lease since a clear precondition thereof, that the production was subject to FERC-approved sales price regulation, no longer obtained. That this was an intrinsic part of the letter is made clear by reference to the controlling regulations. Thus, 30 CFR 250.64 (1970) 24/ provided:

> The value of production, for the purpose of computing royalty, shall be the estimated reasonable value of the product as determined by the supervisor, due consideration being given to the highest price paid for a part or for a majority of production of like quality in the same field or area, to the price received by the lessee, to posted prices, and to other relevant matters. Under no circumstances shall the value of production of any of said substances for the purposes of computing royalty be deemed to be less than the gross proceeds accruing to the lessee from the sale thereof or less than the value computed on such reasonable unit value as shall have been determined by the Secretary. In the absence of good reason to the contrary, value computed on the basis of the highest price paid or offered at the time of production in a fair and open market for the major portion of like-quality products produced and sold from the field or area where the leased lands are situated will be considered to be a reasonable value.

While a number of elements are, therefore, properly weighed in determining the value of production, this regulation establishes two general rules. Thus, in the absence of a determination of reasonable unit value by the Secretary, the highest price paid for the major portion of like quality products sold from the field or area will normally be considered reasonable value. But, in no circumstances, shall the value be less than the gross

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24/ We note, in passing, that appellants have argued that the regulations applicable are those regulations which were in effect as of the date of issuance of the subject lease, and not the present regulations. It is unnecessary to resolve this question with respect to the valuation regulations as we are in agreement with MMS that the substance of those regulations has remained substantially the same.

proceeds actually accruing to the lessee. The Oil and Gas Supervisor's July 16, 1979, letter clearly reflected both of these rules. Thus, since gas prices were then controlled, the controlled price (i.e., "the applicable FERC-approved sales price") would necessarily represent the highest price paid for the major portion of like quality products. Yet the Supervisor was careful to note that, if the seller obtained a higher price ("higher price if received"), royalties would be assessed on that basis.

Once production from the lease was price-decontrolled, however, the letter clearly had no continuing applicability, as there was no longer any applicable FERC-approved sales price which could be used to establish the price paid for the major portion of like quality products. Thus, the first benchmark once again reverted simply to the highest price paid for the major portion of like quality products. We note that appellants make a strenuous challenge to whether MMS has correctly determined this value. We will examine that question, infra. Suffice it for our present purposes to note that, to the extent that appellants contend that the letter of June 16, 1979, prevents assessing value for royalty purposes based on the price paid for the major portion of like quality products, their argument must be rejected.

Appellants also assert that the Department has established, via regulations and policy pronouncements, five rules to be used in determining "reasonable value" 25/ for royalty valuation purposes. See Supp. SOR at

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25/ The discussion which follows will utilize the terms "reasonable value" and "fair market value" interchangeably as they both encompass the same concept.

17-35. Appellants contend that these five rules consist of (1) a pricing floor rule, embodied in 30 CFR 250.64 (1970), that the reasonable value of production will be deemed to be at least as high as the gross proceeds actually received by the lessee from the disposition of that production; (2) an alternative pricing floor rule, also premised in 30 CFR 250.64 (1970), that the reasonable value of production will be deemed to be at least as high as any "reasonable unit value" determined by the Secretary; (3) a general standard that reasonable value is measured by fair market value at the time of production, also premised on language appearing in the 1970 version of 30 CFR 250.64 (1970); (4) a rule recognizing that a price reduced at arm's length to reflect market conditions will be deemed to properly reflect value, based on a letter dated October 19, 1984, from the Director, MMS, to appellants' counsel; 26/ and (5) as a corollary to the preceding rule, a rule providing that prices reduced between affiliates will be tested by a benchmark derived from arm's-length prices, also derived from the October 19, 1984, letter from the Director, MMS. While appellants recognize that the second "rule," i.e., production will be valued at least as high as the reasonable unit value as computed by the Secretary, is not applicable as the Secretary has not established a reasonable "unit value" for production, they contend that the Director's decision was arbitrary and capricious because he only considered one

26/ We are constrained to point out that, quite apart from the questionable assertion that the letter from the Director, MMS, to appellants' counsel can establish binding rules (but see, e.g., Thunderbird Oil Corp., 91 IBLA 195, 204 (1986), aff'd sub nom. Planet Corp. v. Hodel, CV No. 86-679 BB (D. N.M. May 6, 1987); The Joyce Foundation, 102 IBLA 342 (1988); Pamela S. Crocker-Davis, 94 IBLA 328, 332 (1986)), appellants reliance on this letter undercuts its assertion that only regulations (i.e., rules) in effect when the lease issued are properly applied in this appeal (see note 24, supra).

factor, i.e., the price obtained by nonaffiliated producers, to the exclusion of all other considerations.

[5] To the extent that appellants are contending that the Department has established five separate "rules," each of which must be utilized in arriving at the ultimate fair market valuation, their argument does not withstand analysis. Thus, even appellants recognize that two of these "rules" merely establish a floor for the purposes of royalty assessments. In other words, regardless of what fair market value might be deemed to be, the value for royalty purposes will not be permitted to fall below a certain specific value.

That a floor price does not necessarily result in fair market value is easily demonstrated. Thus, we could assume that on a date certain gas has a fair market unit value of $5.00 per MMbtu. On that date, a holder of a Federal lease, either through use of superior bargaining position or shrewdness in negotiations, is able to obtain a price of $6.00 per MMBtu. The floor provision of the regulations simply provides that the lessee will pay royalty based on a value of $6.00 per MMBtu, irrespective of whether or not the lessee can demonstrate that $5.00 per MMBtu is the price at which a willing and knowledgeable seller would sell and a willing and knowledgeable buyer would buy. Thus, the sole relevancy of the actual prices which appellants received, absent independent indicia that these prices constituted fair market value, is to establish a minimum value for royalty purposes.

Appellants' fourth and fifth "rules" are not so much independent methods of ascertaining fair market value as they are application of the general rule set forth at 30 CFR 250.64 (1970) to specific circumstances. Thus, the Director of MMS, in response to an inquiry from appellants' counsel as to situations in which, as a result of negotiations between a producer and purchaser bound by an arm's-length contract, the price of gas is reduced to reflect market conditions, replied that:

> [I]f an arm's length contract, either by renegotiation or by operation of the contract terms, results in a reduced price for the gas, resulting in reduced gross proceeds from the sale, the gross proceeds would be accepted by the Minerals Management Service (MMS) as the basis for determining royalties due on the gas sold.

(Letter from William D. Bettenberg, Director, MMS, to Lynn R. Coleman, counsel for appellants, dated Oct. 19, 1984). This letter continued, however, by noting that, in those situations in which affiliated companies enter into agreements which result in a reduced price for the gas and, hence, a reduced royalty payment to the United States, the Department would look to the prices paid pursuant to arm's-length contracts in the same producing field or area. Id. With one important caveat, we believe that the foregoing correctly states the law. Our concern is with the inference which could be derived from the Director's initial statement that the reduced price received through arm's-length negotiations is, ipso facto, the fair market value for royalty purposes. This is not correct.

Under the regulations in effect in 1970, or in 1984 when the letter was written (30 CFR 206.150 (1985)), it is clear that, while the price obtained by open and free negotiations is a relevant consideration in determining fair market value, the mere fact that a specific price is obtained is not preclusive of a determination that a higher figure represents fair market value. Thus, the simple fact that lower prices are the result of arm's-length negotiations cannot prevent the Department from determining that the new negotiated price does not adequately represent fair market value and requiring the lessee to submit royalty payments on a higher value basis than is actually obtained.

The essential difference between a lowered price obtained by arm's-length negotiations and one which is the result of a non-arm's-length negotiation is that a presumption arises in the first situation that the price obtained fairly reflects the marketplace while, in the latter case, no such presumption can be indulged. Rather, where the contract is between affiliates or subsidiaries, there must be independent indicia establishing that the contract price is one fairly derived from the marketplace. See generally AMAX Lead Company of Missouri, 84 IBLA 102 (1984); Getty Oil Co., 51 IBLA 47 (1980). Indeed, inasmuch as Departmental adjudications had long proceeded along such an analysis, it is obvious that, far from announcing new "rules" in his letter, the MMS Director was merely restating traditional Departmental policy.

The remaining "rule," viz., that, as a general matter, reasonable value is measured by fair market value at the time of production, borders on the tautological. However, it must be noted that the actual language of the regulation on which appellants rely provides:

> In the absence of good reason to the contrary, value computed on the basis of the highest price paid or offered at the time of production in a fair and open market for the major portion of like-quality products produced and sold from the field or area where the leased lands are situated will be considered to be a reasonable value.

30 CFR 250.64 (1970). The interpretation of this provision and the concomitant ascertainment of fair market value are at the heart of this appeal, particularly as it relates to the demand for back royalty for the period from August 1982 through September 1983. This issue is examined in extenso later in the text. At this time, however, we wish to turn our attention to the demand by MMS for additional royalties for the period between March through August 1980.

In the decision under appeal, the Director, MMS, held that TXC underpaid royalty during the period from March through August 1980, since TXC's royalties were based on controlled section 102 prices while Enstar was, during the same period, tendering royalties based on deregulated section 107 prices. The Director concluded that TXC should have tendered the royalties based on the same valuation which Enstar used. The amount of royalty allegedly underpaid during this period aggregated $114,240.62.

Appellants argue that TXC was contractually barred from renegoti-ating a higher deregulated price until August because price could only be redetermined annually under the annual price redetermination provision. However, this assertion is clearly at odds with the pertinent portion of the price provision in the TXC-Transcontinental contract. Thus, Article XI(3) provided, in relevant part:

> If at any time during the term of the contract the Federal Power Commission (or any successor governmental agency having jurisdiction over the rates charged for gas sold thereunder) ceases to have jurisdiction over the price of gas sold, ceases to exercise control over gas sold, or permits indefinite pricing provisions to become operative in a manner applicable under the contract, then, at Seller's request, the parties shall renegotiate the price at which natural gas is to be sold under the contract. Any such request shall be made to Buyer in writing and may be made at any time following the effective date such deregulation or indefinite pricing provisions become operative, and subsequently at intervals not more than once each year. [Emphasis supplied.]

Additionally, section 4 of Article XI provided that "[t]he price so negotiated shall be effective on the first day of the month following the expiration of sixty (60) days from the date of Seller's written request for such renegotiation."

Under this provision, appellants could have requested renegotiation of the price at any time after the effective date of deregulation, November 1, 1979 (see note 23, supra). In fact, Enstar, with virtually the exact same provision, swiftly acted to avail itself of the decontrolled price. Thus, on December 11, 1979, Enstar made an interim collection filing with FERC. Two days later, on December 13, 1979, Enstar filed its Application for Determination under section 107(c) of the NGPA. On this same date, Enstar advised Transcontinental that it was exercising its option under Article XI(3) of its contract.

Enstar's Application for Determination received preliminary juris-dictional agency approval on February 27, 1980, and final approval on April 28, 1980. Final approval from FERC was obtained on June 19, 1980. Pursuant to applicable FERC rules and subject to the contractual arrangements of the producer and the pipeline company, retroactive collection of the higher rates was permitted for any period between the date of filing for the determination of eligibility and the date of determination. Furthermore, if the application for determination was filed on or before June 23, 1980, retroactive collection of the higher prices was permitted for first sales of natural gas delivered on or after November 1, 1979 (see 18 CFR 273.204(a)(2) (1981)).

Thus, reading the applicable FERC regulations in light of the rele-vant provisions of the Enstar-Transcontinental contract, Enstar was enti-tled to the increased prices effective March 1, 1980, and ultimately did receive an increased price of $5.62 per MMBtu for the production between March 1 through March 30, 1980. Furthermore, the new pricing provision provided, until future renegotiation was requested, that commencing on April 1, 1980, and at quarterly intervals thereafter, the price would increase by 1-1/2 percent over the immediately preceding calendar quarter (see Letter-agreement between Enstar and Transcontinental, dated July 10, 1980).

While Enstar acted quickly to obtain the higher prices afforded by decontrol, TXC did not seek to exercise the Article XI(3) renegotiation option under its contract with Transcontinental until July 1, 1980, and, therefore, did not obtain a deregulated price ($6.397 per MMBtu) until September 1, 1980.

As noted above, appellants assert that their failure to obtain a deregulated price at the same time as Enstar was the result of the differing dates on which Enstar and TXC, respectively, entered into their contracts with Transcontinental (Supp. SOR at 5 n.5). This assertion, however, is simply not borne out by the relevant contract provisions. There was no contractual bar to TXC's receipt of higher prices at the same time which Enstar obtained them. Rather, its failure to obtain such prices was the direct result of TXC's failure to diligently and expeditiously request renegotiation of the contract price under Article XI(3).

[6] As MMS notes, where royalty payments are dependent upon the price at which the product is marketed, oil and gas lessees are generally deemed to have an implied obligation to exercise good faith in the market-ing of gas. See, e.g., El Paso Natural Gas Co. v. American Petrofina Co., 733 S.W.2d 541, 550 (Tex. App. 1986); Amoco Production Co. v. First Baptist Church, 579 S.W.2d 280, 285-87 (Tex. Civ. App. 1979); 5 Williams & Meyers, Oil and Gas Law § 856.3. This obligation is strictly enforced where the interests of the lessee and the lessor diverge, as in such a situation it can no longer be expected that the lessee will attempt to maximize the selling price in order to maximize its own return. See Harding v. Cameron,

220 F. Supp. 466 (W.D. Okla. 1963); Amoco Production Co. v. First Baptist Church, supra.

It must be recognized, however, that this obligation does not rise to the level of a fiduciary duty and claims for increased royalties are subject to the defense that the lessee exercised reasonable business judgment. Thus, in Piney Woods Country Life School v. Shell Oil Co., 539 F. Supp. 957 (S.D. Miss. 1982), aff'd in part, rev'd in part and remanded, 726 F.2d 225 (5th Cir. 1984), the court rejected claims that the lessee should have obtained a price renegotiation provision in a gas sale contract, concluding that the terms received represented the best obtainable price. Accord Poafpybitty v. Skelly Oil Co., 517 P.2d 432 (Okla. 1973); Gazin v. Pan American Petroleum Corp., 367 P.2d 1010 (Okla. 1962).

The instant case, however, does not present a situation in which a renegotiation clause was not included and appellants assert that there were sound business reasons for the failure to obtain such a provision. On the contrary, the TXC-Transcontinental contract clearly provided for the renegotiation of the contract price after deregulation. TXC was simply dilatory in seeking a renegotiated price. Appellants have advanced no justification for TXC's failure to timely invoke the renegotiation provisions of its contract with Transcontinental and none comes to mind. We conclude, therefore, that the Director was correct in demanding additional royalties for the period from March through August, 1980, based on his determination that the reasonable value of the gas produced was established by the Enstar renegotiated price. 27/

Appellants point out that the price which TXC obtained, commencing on September 1, 1980, was higher than that received by Enstar for the period from September 1980 through March 1981. This was a result of the fact that this was a period of rapid price escalation with respect to natural gas and thus the price had continued to rise after Enstar had established a renegotiated price with Transcontinental. We recognize that, had TXC not waited until July 1, 1980, to exercise its price renegotiation option, it would have obtained a lower price ($5.62 per MMBtu) and the United States would have received proportionately lower royalty payments for the period from September 1980 through February 1981. Inferentially, appellants argue that it is unfair to assess their royalty at the price obtained by Enstar for the period from March through August 1980, and then base the royalty on the higher rates obtained by TXC from September 1980 to March 1981, when the only reason that these higher rates were obtainable was that TXC had delayed in renegotiating the sale price with Transcontinental.

While there is a certain surface appeal to appellants' argument, deeper reflection shows that it is intrinsically flawed. First of all, as we have held above, the price renegotiated by Enstar represented reasonable

27/ We note that Chevron failed to invoke its right to a price renegotiation until Nov. 6, 1980, and did not obtain a higher price ($6.5904 per MMBtu) until Feb. 1, 1981. While the record before the Board does not establish whether MMS has assessed Chevron for underpayment of royalties between Mar. 1, 1980 to Feb. 1, 1981, we note that the rationale in the text with respect to TXC's obligations would be equally applicable to Chevron's situation.

value for production from the lease for the period from March through August 1980, and appellants were properly directed to compute the royalty value of their production on that basis. After September 1, 1980, how-ever, appellants obtained a higher price. Regardless of whether the price received by Enstar thereafter might still be considered a "reasonable value of the product," after September 1, 1980, appellants were obligated to tender royalties at the higher rate, since the applicable regulation clearly provided that, "[u]nder no circumstances shall the value of production * * * for the purposes of computing royalty be deemed to be less than the gross proceeds accruing to the lessee from the sale thereof * * *." See 30 CFR 250.64 (1970).

Second and of equal importance is the fact that the adverse effects generated by TXC's delay in exercising its renegotiation option were not limited to the period from March through August 1980. As pointed out earlier, under Article XI(3) of both the Enstar-Transcontinental and the TXC-Transcontinental contracts annual price redeterminations were permitted after the initial price redetermination following decontrol. Thus, Enstar was able to obtain another renegotiated price as of March 1, 1981, at a higher rate than that being obtained by TXC. MMS did not, however, attempt to assess appellants additional royalties for this increase. Rather, as was noted in a memorandum dated March 23, 1984, from the Royalty Manager, Houston Regional Compliance Office, MMS, to the Chief, Appeals Division, MMS:

> For the period September 1980 through July 1982, we noted that prices received by TXC for its gas did vary up and down from the prices received by Enstar for its gas. Royalties for Enstar's share of the gas were always based on the FERC approved

> sales prices. In those months where TXC's prices were higher than the arm's-length contract prices received by Enstar, the royalties attributable to TXC's share of the gas were based on their price received which is in accordance with the Oil and Gas Supervisor's instructions. For some months, Enstar's prices were higher than those received by TXC but not to a degree where we sought to question whether the non-arm's-length contract price received by TXC was not similar to the arm's-length contract price received by Enstar. [Emphasis supplied.]

Id. at 5-6.

The decision of the Director, MMS, with respect to the question of additional royalties owing for the period from March through August 1980 is thus a balanced approach which takes into account the need to avoid undue rigidity in the determination of what constitutes a reasonable value for royalty purposes and, at the same time, enforces the obligation of fair and responsible dealing between the lessee and the Government. If appellants find themselves in the position of owing additional royalties for this period it is only because TXC failed to act in an expeditious manner to protect both its own interests and those of the United States.

We turn now to the determination of the MMS Director that additional royalties were also owing for the period from August 1982 through September 1983. As indicated above, until August 1982, the prices received by all three working interest owners of OCS-G 1960 continued to move upward, driven originally by the price renegotiation provisions of their respec-tive contracts with Transcontinental and, subsequently, by the quarterly price escalations built into those contracts. By August 1982, however, the economics of the natural gas market had undergone a radical reversal from the period during which these contracts had been entered into. There is no question but that the natural gas market had proceeded from a short supply situation (a seller's market) in 1978 to a condition marked by an overabundance of supply, at least at previously prevailing prices (a buyer's market) by mid-1982.

The fall in gas prices was made especially precipitous by the simultaneous collapse in elevated oil prices. Since, for many industrial applications, gas and oil may be interchanged, the fall in oil prices led to increased downward pressure on the price of natural gas. 28/ Thus, appellants assert that, by 1982-83, new contracts governing OCS gas were being negotiated for approximately $4.00 per MMBtu. Further, such contracts often contained market-out provisions and normally avoided any take or pay requirements, in direct contrast to those contracts entered into at the end of the 1970's, such as the three contracts between Transcontinental and the working interest owners of the instant OCS lease.

Caught in the middle of this economic reversal were numerous pipeline companies which, in the days when ever-increasing oil and gas prices were deemed an intrinsic part of the economic landscape, had entered into gas purchase contracts with built-in price escalators and large take or pay obligations. Clearly, Transcontinental was numbered among these (see note 12, supra). To the maximum extent possible, these companies invoked

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28/ While there could be substantial initial expense in any switching over from gas to oil or vice-versa, long-term price differentials between oil and natural gas could make these expenditures economical, as, indeed, they had in the early 1970's when rapidly escalating oil prices, at a time of natural gas price control, induced many companies to shift from oil to gas.

market-out provisions and other mechanisms to lower per-unit costs. There still, however, remained a number of gas-purchase contracts which were, because of their provisions, not susceptible to reductions in quantity or in price. Included among these were the three contracts entered into between Transcontinental and TXC, Enstar, and Chevron, respectively. 29/

As noted above, by letter dated June 1, 1982, Transcontinental requested that TXC accept a reduced price of $5.00 per MMBtu (inclusive of tax reimbursement and all other adjustments and escalators) for two gas purchase contracts between TXC and Transcontinental covering production on the OCS, including the contract covering OCS-G 1960. Transcontinental also requested that TXC "voluntarily reduce deliveries and associated potential take-or-pay obligations by 25% from current levels." This letter expressly noted that "[w]hile we recognize that you are not contractually required to agree with our request, your favorable consideration would be appreciated."

In marked contrast with the delay which had preceded TXC's election to renegotiate a deregulated price in 1980, TXC responded to Transcontinental's request with alacrity. By letter dated June 2, 1982, TXC agreed to this price reduction and agreed to make the reduction retroactive

29/ While we noted above that, by 1982, all three contracts contained a limited market-out provision, allowing for a reduction in the price paid where Transcontinental's average rolled-in gas cost at New York City exceeded the Btu equivalent cost of the lowest priced No. 2 fuel oil, this provision was not utilized during the period in question with respect to any of the three gas purchase contracts.

to May 1, 1982. 30/ TXC justified its decision as "in the interest of protecting its long term gas market."

The same request to which TXC so rapidly responded in the affirmative was also apparently sent to both Enstar and Chevron (see Supp. SOR at 23). Neither chose to accept this "proposal." As a result, therefore, while the Enstar price rose from $9.325 per MMBtu in the last quarter of 1982 to $9.607 per MMBtu by the second quarter of 1983, the TXC price remained pegged at $5.00 per MMBtu for its share of production from the same lease.

On May 31, 1983, pursuant to another request from Transcontinental, TXC agreed to a further reduction of price, this time from $5.00 per MMBtu to $4.00 per MMBtu. This agreement was made retroactive to May 1, 1983. It also provided that "in exchange for TXC's agreement to forego revenue otherwise legitimately available to it," Transcontinental agreed that the Excess Royalty provision of the original contract would be applicable to this agreement.

Less than 2 months thereafter, TXC and Transcontinental agreed to a major restructuring of their relationship. As was noted earlier in the

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30/ This was the date that market-out reductions were made effective as to those contracts which Transcontinental had entered into which made allowance for a general market-out. As noted above, however, no such general market-out provision was applicable to the instant TXC-Transcontinental contract. Moreover, by making the decrease retroactive to May 1, 1982, the parties were also amending Article XI(4) of the contract, since that provision clearly made any renegotiated price effective 60 days following the request for renegotiation. Indeed, appellants now suggest that, since they tendered payment for June and July at the "old" contract rate, they should receive a refund for "overpaid royalties" (Supp. SOR at 5 n.5).

text, two agreements were entered into on July 12, 1983. The first, which had an effective date of January 1, 1984, and which we have termed the General amendment, involved a general waiver of outstanding take-or-pay liabilities with respect to a large number of existing contracts, and limited future take-or-pay obligations to TXC's proportionate share of Transcontinental's market. Further, the agreement expressly provided that "[i]n the event [Transcontinental] has not received the volumes of gas paid for but not taken, within five (5) years of the date such deficiency was incurred, TXC shall refund to [Transcontinental], with interest * * * all sums still outstanding for unrecovered volumes." See Section 3 of the General agreement. The effect of this last provision, of course, was to essentially abrogate any take-or-pay obligations on the part of Transcontinental. The putative justification for this agreement was "an effort to maintain the resale markets for the gas produced under the Subject Contracts and improve the stability of those markets."

On that same date, a revision to Article XI of the contract between TXC and Transcontinental with respect to lease OCS-G 1960 was also agreed to, with an immediate effective date. This revision added a new section 8 to Article XI, which, in effect, granted Transcontinental a broad market-out right as opposed to the limited market-out right which had theretofore existed. The agreement recited that the agreed-to revision was in "partial consideration" of Transcontinental's willingness to enter into purchase agreements with respect to certain other gas reserves.

Effective 8 days after these two revisions, TXC transferred all of its assets, including its interest in the subject lease, to Transco Exploration Partners, Ltd. (TXP), in exchange for a 90-percent interest therein. The remaining 10-percent interest was offered and sold to the public. TXP, in turn, operated through TXPO, in which TXP owned a 99-percent limited partnership interest while TXC and Transco Energy Company jointly held a 1-percent general partner's interest. 31/

By letter dated September 27, 1983, Transcontinental informed appellants that its market position had continued to deteriorate. Accordingly, "[i]n an effort to forestall further erosion of the natural gas markets on its system," Transcontinental exercised its newly acquired rights under Article XI(8) to market-out appellants' production from OCS-G 1960. Various pricing options were presented. Appellants chose an option providing $3.40 per MMBtu. 32/

As might well be expected, the sharp decline in royalty payments for appellants' 15-percent interest in the subject lease, particularly when viewed in light of the continued upward trend for the remaining 85 percent

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31/ We note that, while it was the apparent intent of the parties that TXC assign its assets to TXP and then for TXP to reassign them to TXPO (see Letter dated July 15, 1983, from TXC to Transcontinental), in actual fact, TXC assigned its interest in the subject lease directly to TXPO. See Assignment of OCS-G 1960, signed July 15, 1983.
32/ Since this option was only available to suppliers who had more that one gas purchase contract with Transcontinental, at least one of which did not have a market-out provision, it was clear that the availability of this option to appellants was the result of some lease other than OCS-G 1960, since, by this time, the purchase contract covering that lease had been duly impressed with a general market-out provision (see discussion, supra).

of the lease, eventually came to the attention of MMS, and the proceedings which have culminated in this appeal commenced.

[7] While appellants do not dispute the facts set forth above, they strenuously argue that they have tendered the proper royalty for the period in question in conformity with the regulations. Thus, they argue that the Transcontinental market-out prices fairly depicted the reasonable value of gas being produced and sold at the times that those prices were in effect for a majority of the lease interests in the Gulf of Mexico. This, they urge, is the test applicable under 30 CFR 250.64 (1970), i.e., the "value computed on the basis of the highest price paid or offered at the time of production in a fair and open market for the major portion of like-quality products." Appellants contend that, in the absence of even an allegation that they received more money from Transcontinental, the value which they received from Transcontinental demonstrably represented fair market value and served as the basis upon which their royalty payments should be calculated.

MMS counters by noting that the non-arm's-length agreements between appellants and Transcontinental must be examined in the light of the arm's-length Transcontinental transactions with Enstar and Chevron, respectively, which, MMS suggests, are the proper standard from which to determine reasonable value for production, since they represent 85 percent of the production from the lease. Judged in this light, MMS argues, there is no question that the price obtained by appellants does not represent a "reasonable value of the product."

Appellants devote considerable time and effort in an attempt to establish that all natural gas produced from the OCS is intrinsically the same, that the relevant field or area for the purposes of making value comparisons is the entire Gulf of Mexico, and that the market-out prices which Transcontinental was offering to its buyers were reflective of the general market price at that time. The conclusion which they obviously hope to foster is that the price which they obtained for the natural gas for the period from August 1982 through September 1983 was at least as high as the price paid for a majority of like-quality products in the area (if not higher). But, even if appellants were successful on each element of their analysis, 33/ the point which they ignore is that the regulation provides that value computed on the basis of the highest price paid at the time of production for the major portion of like-quality products in the area will be considered a reasonable value, "[i]n the absence of good reason to the contrary." 30 CFR 250.64 (1970) (emphasis supplied). And, compelling reasons exist for declining to accept the prices received by appellants as a "reasonable value" for the production from lease OCS-G 1960.

It may well be true that anyone attempting to make an initial sale of natural gas on the OCS in mid-1982 would have found a price of $5.00 per

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33/ Without embarking on a point-by-point refutation of appellants' assertions, we would suggest that the contention that the entire Gulf of Mexico is the relevant area for comparison of prices borders on the ludicrous. The language in the regulation requires advertence to "the field or area where the leased lands are situated." Since this regulation was originally promulgated in 1954 and, by its terms, applies only to the OCS, all of the leased lands would have been "situated" in either the Gulf of Mexico or off the West Coast. Thus, there would have been no need to make reference to the "field or area" where the lands were "situated."

MMBtu acceptable considering the prevailing market conditions. The fact of the matter, however, is that TXC was not in <u>that</u> market. On the contrary, TXC, through the vicissitudes of fortune, had managed to secure for itself an envious position. It had a contract requiring Transcontinental to purchase 90 percent of its delivery capacity of natural gas (Article VI) at a price ($8.496 per MMBtu as of September 1, 1981, with automatic quarterly escalations of 1-1/2 percent thereafter) substantially in excess of the then-going rate. Moreover, TXC's contract contained a take-or-pay requirement for 90 percent of its delivery capacity, and the contract did not contain a general market-out provision which would permit Transcontinental to obtain relief from adverse market conditions. Yet, in less than 2 years, TXC had managed to exchange this contractual arrangement for one in which it was obtaining $3.40 per MMBtu and which, effectively, had no minimum purchase requirement even at that price. In addition, TXC had waived all future, as well as <u>past</u>, take-or-pay liability. The transcendent question is "Why"?

Appellants really have no answer. They make repeated references to the difficulties in which Transcontinental found itself. But, appellants fail to explain how these difficulties of its purchaser compelled TXC to surrender valuable contract rights and to abandon a dominant bargaining position. Appellants strongly object to the assertion by MMS that the only reason TXC was so receptive to Transcontinental's repeated requests to lower the price which it paid for TXC's production and otherwise abandon a favorable bargaining position was that they were both wholly owned by the same parent corporation. But if this is not the explanation, what is? 34/

From the point of view of the parent corporation, it is generally a matter of no moment as to what price the producer (TXC) can exact from the pipeline (Transcontinental) since these costs will be passed on to the ultimate purchaser. There are, however, important caveats. Thus, to the extent that the producer must pay royalty on the sold product, there is an in-born bias against higher producer prices. The reason for this can be seen in the following example. For the sake of simplicity, we will assume that a producer, subject to a 10-percent royalty interest, is selling 100,000 MMBtu of natural gas for $5.00 per MMBtu. The royalty payment is thus $50,000. If, however, the price goes up to $10.00 per MMBtu, the royalty interest payment rises to $100,000. From the point of view of the producer, this may be readily acceptable since its gross income less royalty has risen from $450,000 to $900,000. However, from the perspective of the pipeline, its expenditure has risen from $500,000 to $1,000,000.

34/ Appellants' contention that no undue influence was exerted by Transco Energy Company over the agreements between Transcontinental and TXC, both wholly owned subsidiaries, is sharply undercut by a contemporaneous statement made before the Federal Energy Regulatory Commission in Docket No. RP-83-96-000. Therein, it was stated:

"Transco has not treated its affiliated producer, Transco Exploration Company (TXC), any more favorably than other producers. In fact, TXC has been treated less favorably than non-affiliated producers in certain circumstances, most notably with respect to Transco's reduction of prices paid to TXC for deregulated gas even under contracts between Transco and TXC which did not contain 'market-out' clauses."

(Written Statement of Transcontinental Gas Pipeline Corp., filed July 5, 1983, at 18 (emphasis in original)). Since Transcontinental was able to "treat" TXC differently only with TXC's consent, the implication seems clear that TXC's consent was not the product of a free choice, uncolored by the affiliated relationship between Transcontinental and TXC, but rather was a direct result of this status.

More importantly, insofar as the parent is concerned, absent consideration of profit, the rise in the price per MMBtu actually has a negative impact on the net return to the parent since the net outflow from the parent has increased from $50,000 to $100,000, the amount of the royalty payment. Of course, so long as the pipeline is able to pass along its increased cost, this creates no problem, particularly if the pipeline's own profit is a function of its expenditures.

Problems result, however, when the pipeline is no longer able to pass along all of its costs. And it is at this point that the nature of affiliated companies distorts the normal marketplace. Thus, generally speaking, a producer will seek to maximize its return, even if its purchaser is suffering an economic loss through the transaction. But where affiliated companies are involved, it is better for the parent corporation that any loss be suffered on the production side rather than the distribution side of the ledger. The reason, of course, is that royalty must be paid on production. Returning to our example, if we assume that the pipeline is only able to allocate $800,000 in income to the purchase price of $1,000,000, the pipeline is losing $200,000 on the transaction. If we assume that the costs of production (not including the royalty interest) is $8.00 per MMBtu, the producer is showing a net profit of $100,000. The parent corporation is thus suffering a net loss of $100,000.

In the above scenario, it is in the economic interest of the parent corporation to lower the price charged to the pipeline. Thus, if the price reverts to $5.00 per MMBtu and all other factors remain the same, the pipeline goes from a $200,000 loss to a $300,000 profit, the producer goes from $100,000 profit to a $350,000 loss and the parent corporation has cut its total transactional loss from $100,000 to $50,000. 35/ This entire reduction, however, is made at the expense of the royalty interest which has seen its income decline $50,000. In effect, the royalty interest is being used to subsidize the pipeline's operating expenses. It is this very real possibility that animates the concerns which arise when affiliated parties deal with each other. It is because of this distortion in the normal economic marketplace that transactions between affiliates are routinely examined closely in order to make sure that the actions are the result of sound business judgment untainted by the special relationship that obtains between affiliated concerns. And it is at this point that appellants have totally failed to posit any justifiable business reason, other than their affiliated status, for their repeated acquiescence in the acceptance of lower prices for the production from the lease.

Certainly, it was not the consideration offered by Transcontinental. No real consideration, whatsoever, was offered for TXC's agreement in June

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35/ We fully recognize that there may well be regulatory constraints on the ability of the pipeline to maintain its selling price where the cost of the gas has declined over 50 percent. But this merely imposes a downward limitation on the economic principles governing the relationship of affiliates in the marketplace. We also note that, in their Reply to MMS' Answer, appellants argued that FERC had determined that interstate gas pipelines would not be allowed to include in their cost of gas prices paid to affiliates which are in excess of the weighted average prices paid in comparable purchases by the pipeline to nonaffiliated suppliers or by other pipelines (Reply at 4). It is, of course, unclear whether this position has any effect on the instant matter, since the ultimate question would be the nature of "comparable" purchases. In any event, this Board is without authority to pass on the wisdom or correctness of FERC's actions in regulating interstate pipelines. See generally Hoosier Environmental Council, 109 IBLA 160, 174 (1989).

1982 and May 1983 to accept $5.00 and $4.00 per MMBtu, respectively, for its production. 36/ Nor was any consideration proffered for the effective abandonment of all take-or-pay liabilities in the General amendment which TXC agreed to on July 12, 1983. Indeed, except for the July 12, 1983, contract amendment adopting a general market-out provision, all of the contractual documents are completely silent as to any benefits flowing to TXC. And even for the July 12 contract amendment, only the most ephemeral form of consideration was offered--an agreement by Transcontinental to purchase gas from other wells at unspecified prices and under unstated terms.

We recognize that there may have been other intangible items which made the Transcontinental "offers" more appealing than they might other-wise seem. Yet, though offered the same arrangement, neither Enstar nor Chevron, the working interest owners of 85 percent of the production from the lease, sought to avail themselves of the opportunity to obtain lower prices under less favorable contractual conditions. Only TXC, a wholly owned subsidiary of Transco Energy Company, agreed to the offer Transcontinental, another wholly owned subsidiary of Transco Energy Company, was making.

Appellants suggest that it would be wrong to impute improper motivation in the foregoing transactions because they have fiduciary

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36/ Admittedly, the May 1983 agreement made a reference to the fact that the "excess royalty payments" protection afforded by Article XI(6) would apply to the arrangement. But, by its own terms, this provision would have responsibilities to their shareholders. This argument is fallacious for two reasons. First of all, the mere existence of fiduciary duties does not establish that those duties have been faithfully discharged. Second, and more critically, no such fiduciary responsibilities existed until July 30, 1983, after all of the relevant contractual revisions had been agreed to by TXC. By the time TXC, the wholly owned subsidiary, transferred the subject lease to TXPO, of which 10 percent is publicly held, the TXC-Transcontinental contract already contained a general market-out provision and no longer contained a realistic take-or-pay obligation. TXC had already agreed to accept $4.00 per MMBtu for its production. In short, the damage had already been done.

We noted above that an oil and gas lessee has an obligation of fair dealing with its lessor. By abandoning the favorable terms of their gas purchase contract with Transcontinental and seeking to pay the royalties owed to the United States on the reduced amounts which they received, appellants violated this duty. In order to ascertain what was a reasonable value of production, the Director, MMS, was perfectly correct in looking to the prices obtained by Enstar, which owned 45 percent of the production from the lease and which was in the same situation as appellants prior to the actions delineated above. His demand for additional royalties plus accrued interest was fully in accordance with the law.

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fn. 36 (continued)
applied under the original contract. A restatement of certain existing rights cannot provide consideration for the abandonment of others.

Accordingly, pursuant to the authority delegated to the Board of Land Appeals by the Secretary of the Interior, 43 CFR 4.1, the decision of the Director, MMS, is affirmed for the reasons set forth above.

James L. Burski
Administrative Judge

I concur:

Wm. Philip Horton
Chief Administrative Judge